

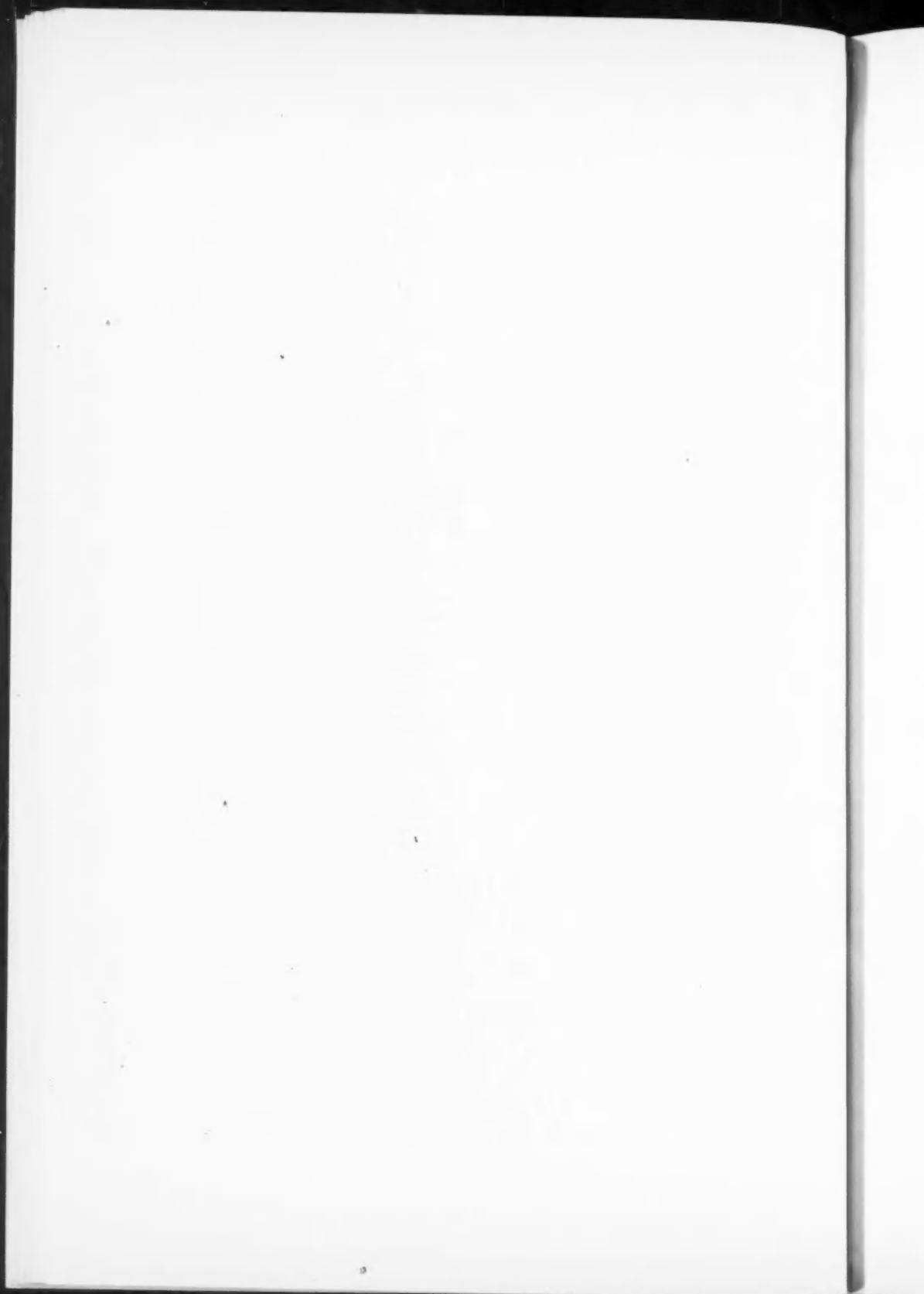
P ROTECTION OF INVESTORS

by

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	PAGE
CONCERN FOR INVESTOR SAFETY IN BULL MARKET	41
Projected U. S. Senate Study of Stock Market	41
Sixteen-Month Rise of Stock Prices to New Peaks	42
Differences Between 1929 and Present Conditions	43
Flare-Up of Frauds in Uranium and Canadian Issues	45
U. S. and Canadian Efforts to Curb Stock Frauds	46
FEDERAL AND STATE LAWS TO SHIELD INVESTORS	48
Protection Afforded Investors by Disclosure Laws	48
Safeguards in Regulatory Provisions of 1934 Act	50
Scope of Regulation and Enforcement by the S. E. C.	51
State "Blue-Sky" Laws for Protection of Investors	53
SELF-REGULATION IN THE SECURITIES BUSINESS	53
Establishment of Self-Policing Trade Association	54
Operation of Over-the-Counter Regulatory Agency	55
Success of N.A.S.D. as Unique Disciplinary Agency	56

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PROTECTION OF INVESTORS

A BULL MARKET that had carried stock prices steadily upward over a period of almost 16 months was abruptly checked in the first week of the new year, when the Federal Reserve Board raised margin requirements on stock transactions. Although the order issued late on Tuesday, Jan. 4, increased the required cash payment on stock purchases and short sales only from 50 per cent to 60 per cent, the market broke sharply the following morning and the selling wave continued into a second day. Recovery then set in, but the market had lost most of its previous buoyancy.

The moderate increase in margin requirements had had the effect of notifying traders that fiscal authorities, though perhaps not yet deeply concerned over the growth of speculative tendencies, at least were watching the market closely; they were prepared in case of necessity to apply curbs that would impose more than a psychological restraint.¹ It became evident simultaneously that members of the new Congress felt some concern over the situation.

PROJECTED U. S. SENATE STUDY OF STOCK MARKET

On Jan. 6, when the securities selling spurt that followed the change in margin requirements was subsiding, Sen. Fulbright (D-Ark.) made it known that the Senate Banking and Currency Committee, of which he was to become chairman, probably would make "a study of the continued sharp climb in the stock market." Fulbright said he was not suggesting an "investigation," but he thought "a study might keep things a little more in balance."

The Fulbright study, voted by the committee on Jan. 14, will include hearings now scheduled to open around Feb. 23. Members of the Federal Reserve Board and Securities

¹ Assessment at Washington of risks in the stock market boom had undergone radical change within the space of a few weeks. As recently as Dec. 15, F.R.B. Chairman Martin said he would not favor raising margin requirements unless margin trading "got out of hand." Treasury Secretary Humphrey had concluded on Dec. 6 that there was "nothing . . . the government could appropriately do at this time."

Editorial Research Reports

and Exchange Commission, Treasury officials, heads of the New York and American stock exchanges, and others with special knowledge are expected to testify. First inquiry of the sort since the Senate Banking Committee, with Ferdinand Pecora as counsel, investigated stock exchange practices in 1933, the study will focus new attention on the safeguards set up since then to protect investors against fraudulent promotions as well as against vagaries of the stock market itself. Both Fulbright and Sen. Capehart (R-Ind.), ranking minority member of the committee, have emphasized that the current inquiry will be of an educational nature. Ruling out anything like a witch hunt, Fulbright at the same time said on Jan. 14 that "The remarkable rises in market prices . . . certainly warrant the committee's concern and study."

The stock market's recent behavior may come under the scrutiny also of the Senate-House Joint Committee on the Economic Report. Rep. Patman (D-Tex.), vice chairman of that committee, has shown interest in probing into the market rise, as have Sens. Flanders (R-Vt.) and Sparkman (D-Ala.), members of the committee.

SIXTEEN-MONTH RISE OF STOCK PRICES TO NEW PEAKS

The steady rise in the market after mid-September 1953 and a fresh spurt after the November 1954 elections lifted stock prices to record high levels. The fact that the market has gone up so far and for so long a period has stirred considerable uneasiness over the possibility of a collapse that would seriously injure the economy, as well as investors large and small. The rise of security prices appears to have been promoting the spread of a get-rich-quick attitude and drawing the public increasingly into stock trading, while plenty of such low-priced issues as uranium stocks have been available to feed the speculative urge of new and inexperienced buyers. Meanwhile, disclosures of fraud in a number of those issues have served to remind of the need for continued vigilance to protect the public against market hazards.

An indication of the expansion in trading that has accompanied the rise in prices is given by the growth of the daily turnover of shares on the New York Stock Exchange; three-million-share days have become commonplace, and there has been an occasional four-million-share day. The

Protection of Investors

RISE OF STOCK PRICES, SEPTEMBER 1953-DECEMBER 1954

(Dow-Jones averages of 30 industrial stocks)

1953	Monthly index	1954	Monthly index
Sept.	261.90	May	322.86
Oct.	270.73	June	327.91
Nov.	277.10	July	341.27
Dec.	281.15	Aug.	346.06
1954		Sept.	352.71
Jan.	286.64	Oct.	358.30
Feb.	292.13	Nov.	375.50
Mar.	299.15	Dec.	404.39*
Apr.	310.92		

* Index for Dec. 31.

trading of 5.3 million shares on that exchange on Jan. 6 represented the largest volume for one day since Sept. 5, 1939, just after the outbreak of World War II. A total of 573.4 million shares changed hands on the New York Stock Exchange last year, the greatest number in any year since 1933.

From a low of 255.49 on Sept. 14, 1953, the Dow-Jones average of 30 leading industrial stocks rose to an all-time high of 408.89 on Jan. 3, 1955. At the peak the industrial average was more than 100 points above the 1953 daily high of 293.79, nearly twice the 1946 high of 212.50, and well above the 1929 high of 381.17.² Stock prices in general, at the beginning of 1955, had risen about 65 per cent in less than 16 months.

With economic forecasts for the year ahead almost all favorable, the feeling was strong that stock prices only reflected satisfaction with the present state of business and confidence in its future, and that the market rise would continue. At the same time, some financial analysts anticipated "correctional reactions" and spoke of "overdue adjustments." The break that followed the increase in margin requirements—the worst break since the start of the Korean war in 1950—reportedly did not worry Wall Street.

DIFFERENCES BETWEEN 1929 AND PRESENT CONDITIONS

Although there are certain similarities between existing business and financial conditions in the United States and those that prevailed in 1929, the year of the great stock

² It should be noted that the 1929 dollar was worth considerably more than the 1955 dollar. *Fortune* magazine estimated (November 1954) that the Dow-Jones index would have to go up to 572 to reach the equivalent of its 1929 mark. President E. T. McCormick of the American Stock Exchange said, Jan. 6, that comparison of "today's securities prices with those of 1929 has no valid basis."

Editorial Research Reports

market crash, most experts contend that the similarities are only superficial and that there actually are wide differences. The soaring 1929 stock market was built to a large extent on credit transactions, whereas today's boom has a strong cash underpinning. Customer loans by broker members of the New York Stock Exchange mounted to \$8.5 billion in September 1929 but totaled only \$1.7 billion on Nov. 30, 1954.³ The 1929 borrowings represented nearly 10 per cent of the value of shares listed on the exchanges, and the 1954 borrowings only about 1 per cent. The present margin requirement of 60 per cent contrasts with cash down payments of only 10 to 15 per cent on stock purchases in 1929. Although speculation seems to have been increasing lately, buying in general today has been more for investment purposes than for speculation. That fact is evidenced by a comparison of turnover rates for shares listed on the New York Stock Exchange—19 per cent in 1954 as against 119 per cent in 1929.

At the peak of the 1929 speculative spree the ratio of stock prices to earnings of the 50 industrial stocks on Standard & Poor's index was about 19 to 1; on Dec. 31, 1954, it was around 13 to 1. Twenty-five years ago, the average dividend yield of high-grade industrials was about 3.3 per cent; currently, it is around 4.3 per cent. In 1929, high-grade corporate bonds yielded considerably more than good industrial stocks, but today the reverse is true. Perhaps most important of all, the real value of stocks, as measured by corporation assets, has increased tremendously over 1929; stockholder equity therefore is much greater now than it was in the earlier period.

FACTORS CONTRIBUTING TO MARKET STABILITY TODAY

One factor which makes for stability in the market today is the ownership of perhaps as much as one-third of all stocks by such institutional investors as banks, insurance companies, college endowment funds, investment trusts, pension funds, and profit-sharing trusts. Institutional buyers, much less interested in quick profits than in sound investments, generally make little effort to time their purchases with swings of the market. Their buying consequently has caused disproportionate increases in prices of the so-called "blue chips."

³ However, the volume of credit outstanding in the securities markets had risen 30 per cent during the preceding ten months of 1954. New York bank loans to brokers and dealers at the beginning of 1955 were larger than they had been for a decade.

Protection of Investors

Sumner Slichter of Harvard has pointed out that "The support to prices from a steady demand for the best stocks helps provide the foundation on which a boom in stock prices can be built."⁴ Despite this inflationary influence and despite the fact that the large holdings of institutional investors may pose a theoretical threat to market stability, it is generally agreed that their operations have "tended not only to stabilize the market but to add values to the securities held by the general public as, undoubtedly without these operations, the general price level of stocks would have been lower than today."⁵

Another factor contributing to the stability of the market is the current level of taxation. The heavy federal levies militate against the taking of profits and influence investors generally to hold on to their stocks rather than offer them on the market. Finally, the 1955 situation differs radically from that of a quarter century ago in that abuses stemming from manipulation, from excessive credit and speculation, and from lack of adequate information on the financial condition of corporations have been mitigated by legislation adopted in the 1930s.

FLARE-UP OF FRAUDS IN URANIUM AND CANADIAN ISSUES

Concern for the safety of the investor has been mounting, for one reason, because opening up of the new field of atomic energy has tempted unscrupulous promoters to exploit the universal itch to make an overnight fortune. The resultant torrent of speculation in so-called penny stocks (selling for a few cents a share), mainly U. S. and Canadian uranium issues⁶ and Canadian oil and mining stocks, has drawn in great numbers of gullible persons and seriously disturbed responsible investment houses as well as the Securities and Exchange Commission.

Some New York brokerage firms have refused to handle certain securities, and others have ruled that, if a customer insists on buying such stocks after warnings to the contrary, he must sign a statement certifying that the firm did not solicit the business and handled the transaction only at his request. President Walter A. Schmidt of the Invest-

⁴ Sumner Slichter, "Wall Street as a Barometer: An Analysis," *New York Times Magazine*, Oct. 3, 1954, p. 39.

⁵ Ward Gates, "Transformation of American Industry—Companies—Investments," *Magazine of Wall Street*, Oct. 16, 1954, p. 99.

⁶ According to *Investor's Reader* of Dec. 1, 1954, more than seven million shares of low-priced uranium stocks have changed hands in Salt Lake City, center of uranium stock trading, in a single day.

Editorial Research Reports

ment Bankers Association said on Dec. 2 that he was afraid "Some people are going to lose a lot of money." Schmidt announced that the I.B.A. would conduct an intensified educational campaign to warn American investors against the risks in speculative uranium, mining, and oil stocks.

Former New York State Attorney General Nathaniel Goldstein estimates that fraudulent stock promotions have cost U. S. investors \$3.5 billion in the past 12 years. Goldstein has voiced particular concern over the reappearance of "boiler-room" salesmen, who use the telephone to sell dubious or even worthless stocks to persons on "sucker lists"; he estimated last autumn that as many as 100 or 150 boiler rooms, some located in Canada, were soliciting residents of New York state alone. President G. Keith Funston of the New York Stock Exchange has warned against "Operation Sucker . . . rolling down from Canada" and cautioned would-be investors against letting "rat-hole salesmen" bamboozle them into "prospecting by stock certificate." Funston has publicized an estimate that "out of 10,000 penny-stock ventures touted by the high-pressure boys, perhaps only one . . . [may turn] out to be profitable."⁷

U. S. AND CANADIAN EFFORTS TO CURB STOCK FRAUDS

To combat fraudulent stock promotions, the U. S. and Canadian governments put in effect on July 11, 1952, a revised treaty to facilitate the extradition to this country of persons indicted for securities frauds. This made feasible the adoption by the Securities and Exchange Commission of its so-called Regulation D, which exempted certain Canadian securities issues, not in excess of \$300,000, from the registration requirements of the Securities Act of 1933.⁸ The S.E.C. and the Ontario Securities Commission then entered into a working agreement under which the Ontario authority, on Mar. 26, 1953, required Ontario broker-dealers to register with the S.E.C. and abide by its rules when selling Canadian securities in the United States.⁹

As a result of these measures and the "splendid cooperation" of the Ontario Securities Commission, the S.E.C. was able, in September 1953, to report a "virtual cessation" of

⁷ G. Keith Funston, "It's Your Money," *The Exchange*, November 1954, pp. 1, 2. James B. Weir, chairman of the Montreal Stock Exchange, agreed on Nov. 9, 1954, that Funston's remarks were "substantially correct."

⁸ See pp. 48-49 for registration requirements and exemptions.

⁹ On Oct. 31, 1954, 53 Canadian broker-dealers were registered with the S.E.C. and 44 applications for registration either had been denied, canceled or withdrawn.

Protection of Investors

fraudulent stock promotions in this country. But the future of the arrangement to protect investors was put in doubt, Nov. 16, 1954, when Chairmen O. E. Lennox of the Ontario Securities Commission announced withdrawal of the restrictions earlier placed on Ontario broker-dealers.

Among the reasons given for the action were (1) that Regulation D operated to allow certain U. S. companies to issue securities based on possibly dubious Canadian mining claims, with the result that the companies became identified in the public mind as Canadian, rather than U. S., ventures; and (2) that Ontario companies were able to issue securities and offer them for sale through U. S. dealers without first qualifying them under Ontario regulations. At the same time, however, Lennox told Ontario broker-dealers that "high-pressure methods prejudicial to the industry at large" would not be tolerated, and the Broker-Dealers Association of Ontario warned its members to comply rigidly with Ontario securities laws or suffer expulsion.

The problem of combating across-the-border stock frauds was complicated by the fact that the 1953 clean-up in Toronto had caused a number of high-pressure securities dealers to shift their operations to Montreal. The chairmen of the two Montreal stock exchanges felt it necessary, late in September 1954, to caution their members not to deal with non-member brokers "selling highly speculative stocks to United States residents . . . in contravention of . . . United States security laws." Quebec securities authorities canceled the registrations of nearly a dozen broker-dealers during the last quarter of 1954. But American efforts to curb fraudulent stock schemes received a setback, Dec. 17, 1954, when, in the first test of the revised extradition treaty, a Montreal court refused a U. S. request for the extradition of two securities dealers from Montreal to Detroit.

S.E.C. Chairman Ralph H. Demmler announced, Dec. 22, that the S.E.C. was "restudying its regulations and policies governing the sale of Canadian securities in the United States, for the purpose of formulating a more effective program for the prevention of fraudulent offerings or other unlawful sales of such securities in this country." The Ontario Securities Commission welcomed the S.E.C. action, and Premier Duplessis of Quebec announced on Jan. 7 that he planned to sponsor legislation to establish a three-man board to supervise stock market activity in that province.

Federal and State Laws to Shield Investors

TO PROTECT the investor the state and federal governments have enacted statutes to shield him from the hazards of deception, fraud, and insufficient information. Various state "blue-sky" laws and the federal "truth-in-securities" laws are designed to afford protection by requiring disclosure of the financial condition of corporations and by providing for regulation of trading practices. Such laws aim to facilitate informed investment analyses and discriminating investment decisions; they attempt to make it certain that the investor's successes or failures will depend mainly on his own prudence and business acumen or the lack of those qualities. Unlike the laws of some states, the federal statutes do not authorize any government agency to disapprove security issues for lack of merit. The federal acts limit the government's role to insuring that the investor shall have the facts and a remedy in case of fraud.

PROTECTION AFFORDED INVESTORS BY DISCLOSURE LAWS

The Securities Act of 1933 and the Securities Exchange Act of 1934 provide for the disclosure to the investor of material facts upon which he may judge the merits of securities offered for sale. The first of these requires that any new securities offered for public sale—unless otherwise exempted—be registered with the Securities and Exchange Commission.¹⁰ Registration calls for description of the securities to be sold, information on the registrant's business and management, and certified financial statements on the condition of the issuer. In addition, a prospectus, containing the salient data in the registration statement, must be furnished the prospective purchaser.

Registration statements are examined by the S.E.C. to determine whether they are complete and accurate.

The *only* standard which must be met in . . . registration . . . is an adequate and accurate disclosure of the material facts concerning the company and the securities it proposes to sell. The fairness of the terms of the securities (whether price, promoters' . . . profits,

¹⁰ With the Federal Trade Commission until the S.E.C. was established in 1934. Exemptions include (1) private offerings to persons who have access to the kind of information which registration would disclose; (2) intrastate offerings; (3) offerings by municipal, state, federal, and other governments, charitable institutions, banks, and carriers subject to the Interstate Commerce Act; and (4) offerings not in excess of \$300,000.

Protection of Investors

or otherwise), the issuing company's prospects for successful operation, and other factors affecting the merits of securities have no bearing on the question whether securities may be registered.¹¹

Although registration does not guarantee the accuracy of the facts set forth in the statement, the law makes false or misleading statements punishable by fine or imprisonment or both. During the year ended June 30, 1954, a total of 831 issues, representing nearly \$9.2 billion worth of securities, became effectively registered.

As an aid to small business, the 1933 act provided that an issue of securities not exceeding \$300,000 need not be registered. However, the issuer was required to file a "notification" containing pertinent information, though in far less detail than stipulated for a registration statement.¹² An administration move at the 1954 session of Congress to raise the exemption from \$300,000 to \$500,000 won Senate approval but failed in the House. Opponents maintained that the higher exemption would be dangerous because it would relieve speculative and promotional companies of the closer scrutiny afforded by registration.

The 1934 act extended the disclosure provision, originally applicable only to new securities, to all securities listed on national securities exchanges. It required that such securities be registered with the S.E.C. and with the exchange on which they are listed.¹³ In addition, the 1934 act provided that further information about the condition of corporations whose securities are listed should be made available to the public; such corporations must file annual and other periodic reports disclosing pertinent financial and management data in order to keep current the information originally filed. The Securities Exchange Act, moreover, sought to enable holders of listed securities to vote intelligently on corporate matters by requiring that proxy statements disclose all material facts concerning proposals to be voted on at stockholder meetings.

The various protections of the 1933 and 1934 laws still do not extend to securities which were issued before the 1933 act became effective and which have not been listed on an exchange and therefore are not registered. Detailed studies were made by the S.E.C. in 1946 and 1950, and

¹¹ S.E.C., *The Work of the Securities and Exchange Commission* (pamphlet, Nov. 1, 1954), p. 2.

¹² A total of 1,175 notifications, covering proposed offerings of more than \$187 million, was filed during the fiscal year 1954.

¹³ A total of 4,147 issues was listed on national securities exchanges and registered on Dec. 31, 1954.

Editorial Research Reports

Sen. Frear (D-Del.) introduced bills to require corporations having more than \$3 million in assets and as many as 300 shareholders to maintain the same safeguards for the protection of investors as those maintained by corporations listed on national securities exchanges. These objectives were endorsed by the White House, the S.E.C., and representatives of the securities industry, but Congress took no final action.

SAFEGUARDS IN REGULATORY PROVISIONS OF 1934 ACT

Whereas the Securities Act of 1933 is primarily a disclosure statute, the Securities Exchange Act of 1934 is primarily a regulatory law. It was designed to insure maintenance of fair and honest markets in securities, both on the exchanges and in over-the-counter (unlisted securities) markets, by regulating trading practices.

The 1934 act prohibits, under penalty of fine or imprisonment or both, manipulation of security prices in trading on a national securities exchange and outlaws the use of "any manipulative or deceptive device" in connection with the purchase or sale of any security. Other provisions of the law curb improper use of "inside" information by requiring every officer and director of a company whose securities are listed on an exchange, as well as each beneficial owner of more than 10 per cent of such securities, to file with both the exchange and the S.E.C. initial and monthly reports showing his holdings and any changes that have occurred.

Registration of national securities exchanges themselves also is required by the 1934 act. To become registered, an exchange must agree (1) to comply with the act, (2) to enforce compliance by its members, and (3) to furnish such data as to its organization, membership, and rules as the S.E.C. may require. The S.E.C. must be satisfied that the rules of the exchange, in general, insure fair dealing and the protection of investors and, in particular, provide for the disciplining, including expulsion, of members for improper trading conduct.¹⁴ All national securities exchanges, their members, and all registered broker-dealers must keep such records and make such reports as the S.E.C. may prescribe.

Brokers and dealers who conduct an over-the-counter

¹⁴ Five of the 16 registered national securities exchanges reported disciplinary action against 33 members, member firms, and partners of member firms during fiscal 1953, latest year for which the official data are available. Actions taken ranged from a \$1 fine to expulsion from exchange membership.

Protection of Investors

business not confined to one state or to exempted securities must register with the S.E.C.¹⁵ The 1934 law further provides for the segregation of the functions of brokers and dealers.¹⁶ It makes it unlawful for any broker-dealer to effect any security transaction with a customer unless he "discloses to such customer in writing, at or before the completion of the transaction, whether he is acting as a dealer for his account, as a broker for such customer, or as a broker for some other person."

It was the Securities Exchange Act which gave the Federal Reserve Board authority to prescribe limitations on margin transactions "for the purpose of preventing the excessive use of credit for the purchase or carrying of securities." Previously, the amount of credit extended to a customer had been limited only by the broker or by the exchange. Brokers, dealers, or others who extend credit for the purchase of securities now must report to the Federal Reserve Board. Margin requirements were fixed initially in 1934 at about 28 per cent, raised as high as 100 per cent in 1946 and early 1947, and maintained at 50 per cent from Feb. 20, 1953, until raised to 60 per cent on Jan. 5, 1955.

SCOPE OF REGULATION AND ENFORCEMENT BY THE S.E.C.

It is the duty of the S.E.C. to administer and enforce the various statutes enacted to protect investors.¹⁷ The agency is empowered, in the words of Commissioner J. Sinclair Armstrong, "to make rules designed to protect the public by maintaining free, open, fair, and honest securities markets, . . . to prevent manipulation and rigging of prices, and to stamp out, so far as any law enforcement agency can, deception and fraud."¹⁸

The commission's enforcement activities aim at preventing fraud in the purchase or sale of securities. To that end,

¹⁵ Registrations effective Oct. 31, 1954, totaled 4,180.

¹⁶ A broker serves as the customer's agent in buying or selling securities and may charge only a fixed commission. A dealer, on the other hand, acts as a principal and buys securities from, or sells securities to, his customer; a dealer, buying or selling for a profit, normally may not charge the customer a fee or commission for any services rendered.

¹⁷ The S.E.C. is an independent, bipartisan, quasi-judicial agency, composed of five members—not more than three of whom may be members of the same political party—appointed by the President for staggered five-year terms. Although most of its enforcement activities arise under the Securities Act of 1933 and the Securities Exchange Act of 1934, the S.E.C. administers also the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and Chapter X of the Bankruptcy Act.

¹⁸ Speech before Commonwealth Club of California, San Francisco, Nov. 12, 1954.

Editorial Research Reports

the S.E.C. investigates complaints or other indications of possible law violations in securities transactions. It uses the evidence obtained in such investigations to support (1) administrative proceedings, such as revoking the registrations of brokers and dealers or suspending or expelling them from the exchanges or from the securities dealers' association; (2) court orders enjoining fraudulent practices; or (3) criminal prosecution of persons wilfully engaged in fraudulent activities.

Under the Securities Act of 1933, the S.E.C. may refuse to make effective, or may suspend the effectiveness of, any statement of registration for new securities if it finds the representations in the statement misleading, inaccurate, or incomplete. No refusal or stop orders have been issued for several years. On the other hand, Commissioner Armstrong told an Investment Bankers Association group at Chicago, last Apr. 1, that during the year ended June 30, 1953, inspection of 683 broker-dealers, authorized by the 1934 act, disclosed 655 infractions of the securities laws and S.E.C. regulations. Although many of the violations were minor, the S.E.C. pointed out in its annual report that "in a limited number of instances brokers and dealers were taking secret profits."

In guarding against manipulation in the securities markets, the S.E.C. continuously watches exchange tickers, quotation sheets, and other media for unusual market activity and unexplained price deviations. When unusual market behavior bears no apparent relation to known developments and indicates the probability of manipulative practices, the S.E.C. makes an investigation.

During the two decades ended June 30, 1953, S.E.C. actions instituted for violations of the acts which it administers resulted in 574 injunctions and 1,179 convictions. Chairman Demmler said, Jan. 2, that the commission had been "engaged in a program of . . . tightening up . . . enforcement and inspection procedures." Of even greater significance to the investing public than the many instances in which the sanctions of law have been invoked, however, is the "prophylactic effect of the very existence of the fraud prohibitions . . . and the commission's powers of investigation and enforcement."¹⁰

¹⁰ S.E.C., *The Work of the Securities and Exchange Commission* (pamphlet, Nov. 1, 1954), p. 10.

Protection of Investors

STATE "BLUE-SKY" LAWS FOR PROTECTION OF INVESTORS

Since 1911, when Kansas enacted the first "blue-sky" law, virtually all the states have adopted legislation pertaining to the sale of securities and designed to give investors varying degrees of protection against fraudulent promotions. Thirty-seven states require payment of license fees by securities dealers and registration fees by issuers of securities. Payment of the dealer's fee alone is required by four states; payment of only the registration fee, by three states. One state, Maryland, requires registration of dealers without exacting a license fee. Delaware and Nevada, as well as the District of Columbia, have no blue-sky laws. New Jersey, on the other hand, has a blue-sky law but no blue-sky regulations. A number of the states have anti-fraud laws which apply to dishonest dealings in securities.

Some states have set up special securities commissions to administer the blue-sky laws. Others authorize the state attorney general or the secretary of state to perform this task. Several of the blue-sky laws provide for the "qualification" of securities issues—in effect, the approval or disapproval of particular offerings. Close cooperation is maintained between the state securities administrators and the federal Securities and Exchange Commission. The federal securities statutes specifically provide that they are not to supersede or derogate from the state laws; cases in which the establishment of a federal violation is doubtful or difficult to prove are referred to the state authority.

Self-Regulation in the Securities Business

THE BIGGEST SEGMENT of the securities business — over-the-counter trading — is largely self-regulated within the framework of the Securities Exchange Act of 1934 and under the general supervision of the S.E.C. Inasmuch as the broker-dealers engaged in over-the-counter trading do business in unlisted securities and are not organized into an exchange which can regulate their activities, an instrument for exercising control was essential.

The size of the problem may be judged from the fact that quotations on about 25,000 over-the-counter securities are published during the course of a year, as contrasted with

Editorial Research Reports

the 4,000-odd securities listed on exchanges. Before 1939 there were no formally established standards in the over-the-counter market, and no one had responsibility for publishing prices on the securities so traded. In contrast with the disorderly situation which then prevailed, the over-the-counter market today is highly regulated.

ESTABLISHMENT OF SELF-POLICING TRADE ASSOCIATION

Order was brought into the over-the-counter field chiefly through the efforts of the National Association of Securities Dealers, a self-policing trade organization. Because the Securities Exchange Act of 1934 had given the S.E.C. only very general power to control conduct in the over-the-counter market, Congress in 1938 adopted an amendment providing for development of a "mechanism of regulation among over-the-counter brokers and dealers."

It [the amendment] represented a deliberate choice by Congress between two alternatives: greatly expanding the powers and functions of the S.E.C., providing for regulation of business ethics by an agency of the state; or providing for regulation by the businessmen themselves through their own association or associations which would have power over their members comparable to the power of an exchange. Congress, explicitly recognizing the choice, chose the latter alternative. . . . Congress . . . determined that it wished to rely upon the processes of a private agency to exercise social control; in effect, it determined that a state agency . . . was too unwieldy, expensive and awkward.²⁰

Although the law permitted creation of a number of regulatory organizations, only one was established—the National Association of Securities Dealers, set up in 1939. The legislation was intended to authorize the association to establish ethical as well as legal standards, and to cope with business methods which, while technically not illegal, were nevertheless unfair to both customer and competitor.

The 1938 amendment provided that the regulatory association—in effect, the N.A.S.D.—should be registered with the S.E.C. Registration, in turn, required that the N.A.S.D. rules provide (1) for exclusion of disqualified broker-dealers, (2) for the disciplining of members for violations, and (3) for review of such disciplinary actions by the S.E.C. The rules, furthermore, had to be designed to prevent fraud, manipulation, and unreasonable profits or charges, to promote a free-market, and in general to protect investors.

²⁰ Howard C. Westwood and Edward G. Howard, "Self-Government in the Securities Business," *Law and Contemporary Problems*, Summer 1952, pp. 526, 529.

Protection of Investors

The N.A.S.D. has adopted rules that require its members to deny dealer and other concessions to non-members. Hence a broker-dealer who wishes to enjoy such concessions as generally are essential to any substantial over-the-counter business must be an N.A.S.D. member in good standing. The N.A.S.D.'s power to exercise controls in the over-the-counter field rests on its ability to deny concessions to non-members.²¹

OPERATION OF OVER-THE-COUNTER REGULATORY AGENCY

The N.A.S.D. has carried out the provisions of law which gave it birth by demanding that its members comply with its rules of fair practice, uniform practice code, and other regulations. The cardinal principle of the rules of fair practice requires members "to observe high standards of commercial honor and just and equitable principles of trade." This was interpreted by the N.A.S.D.'s board of governors in 1943 to mean that "It shall be considered conduct inconsistent with just and equitable principles of trade for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security."

The uniform practice code, adopted in 1941, defines terms and prescribes methods for trading in the over-the-counter market. Development of the N.A.S.D. system of quoting market-price ranges on unlisted securities has brought about responsibility in public pricing of securities. Under this system, the N.A.S.D. sponsors the publication of over-the-counter quotations which represent, as accurately as can be determined, the ranges within which N.A.S.D. members stand ready to buy or sell securities.

Administration of the N.A.S.D., which has approximately 3,200 members, is carried out on the national level by an elected board of governors and on the regional level by 14 elected district committees. Each district committee either appoints, or itself acts as, a business conduct committee; the conduct committee is the organ which receives complaints.

Complaints may be instituted by a member of the public, a member of the N.A.S.D., or by the N.A.S.D. itself. The district business conduct committee has the right to examine members' records and to hold a hearing, after

²¹ *Ibid.*, p. 528.

Editorial Research Reports

which it may impose such penalties as censure, fine, suspension, or expulsion from the association.²² Decisions may be appealed to the board of governors, to the S.E.C., and to the courts.

SUCCESS OF N.A.S.D. AS UNIQUE DISCIPLINARY AGENCY

The success of this unique institution, an "outstanding example of voluntary industry self-discipline,"²³ may be attributed to the fact that it has been able to carry out the intent of the law to the satisfaction of both the S.E.C. and the securities industry. Although the N.A.S.D. performs many of the traditional functions of a trade association, it is clear that its duties extend much further. Under the law the S.E.C. can suspend or revoke the N.A.S.D.'s registration if it finds that the association has failed to enforce compliance with its own rules, but it has never had occasion to consider such action. The S.E.C. has given unmistakable indications, however, that it would "not be likely long to tolerate any tendency on the part of the N.A.S.D. to slight its enforcement function."²⁴

Evidence of the success of the N.A.S.D. may be seen in the fact that since it was formed, the federal government has imposed few additional regulations on over-the-counter dealers. Furthermore, there have been comparatively few cases in which the S.E.C. has been asked to review N.A.S.D. rulings. In only one case has one of its rulings been appealed as far as the Supreme Court, and then the Court upheld the decision of the N.A.S.D. to expel a member firm.

²² During 1954, 11 members were censured, 12 fined, 1 suspended, and 4 expelled.

²³ S.E.C. Commissioner J. Sinclair Armstrong, speaking before Commonwealth Club of California, San Francisco, Nov. 12, 1954.

²⁴ Howard C. Westwood and Edward G. Howard, "Self-Government in the Securities Business," *Law and Contemporary Problems*, Summer 1952, p. 533.



